VZCZCXRO5664
RR RUEHAG RUEHAST RUEHDA RUEHDBU RUEHDF RUEHFL RUEHIK RUEHKW RUEHLA
RUEHLN RUEHLZ RUEHPOD RUEHROV RUEHSR RUEHVK RUEHYG
DE RUEHPG #0758/01 1770624
ZNR UUUUU ZZH
R 260624Z JUN 07
FM AMEMBASSY PRAGUE
TO RUEHC/SECSTATE WASHDC 9283
INFO RUEHZL/EUROPEAN POLITICAL COLLECTIVE
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
RHEHNSC/NSC WASHDC
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 02 PRAGUE 000758

SIPDIS

SIPDIS

STATE FOR EUR/NCE, EUR/ERA, EB/IFD/OMA, E STAFF
TREASURY FOR OASIA ANNE ALIKONIS
STATE PLEASE PASS USTR WENDY MOORE
COMMERCE FOR ITA/MCA/EUR MIKE ROGERS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV EZ PGOV
SUBJECT: CZECH REPUBLIC: ECONOMY REMAINS ROBUST AS FISCAL
DISCIPLINE REMAINS THE WEAK LINK

REF: A. PRAGUE 698

¶B. 06 PRAGUE 1173

¶1. SUMMARY AND COMMENT: The Czech government on June 11 approved a preliminary 2008 budget deficit of CZK 78.4 billion (3% of GDP). However, these figures are entirely dependent on the passage of the economic reform package (ref A), which Parliament will address after returning from its summer recess August 7. The government will submit the final 2008 budget to Parliament by end-September for approval by end-year. In the meantime, despite continued erosion in public finances, the Czech economy is outperforming expectations of a moderate slowdown and may once again reach 6% GDP growth in 2007. Household consumption and exports are leading GDP growth, and accompanying this growth is much speculation about a credit bubble. There has been significant and steady growth in household credit since 2003, but the overall level as a proportion of GDP remains far below the EU average and the Czech National Bank does not believe it poses a significant macroeconomic risk. Despite the robust growth, economists continue to warn that public finances must be reined in quickly because structural growth is slowing. Therefore, the pending economic reform package in Parliament will impact not only the political future of the coalition government, but also the sustainability of rapid growth for the medium to long term. END SUMMARY AND COMMENT.

ECONOMY DEFYING PREDICTIONS OF SLOWDOWN

¶2. The Czech Ministry of Finance forecasts 2007 GDP growth at 4.9%. The OECD in May said that economic growth in the Czech Republic would slow from last year's 6.1% of GDP to 5.5% this year and 5.0% in 2008, citing a lower pace of consumption growth and an anticipated decline in exports. The Czech National Bank forecasts GDP growth at a range of 4.9 - 6.5% for 2007 and 3.8 - 6.8% for 2008. However, stronger-than-anticipated export and consumer demand data from the first four months of the year indicate these forecasts may need to be revised upward to somewhere closer to 6%.

¶3. According to the Czech Statistical Office, Czech exports during the first four months of 2007 are up 17.4% from the same period last year while imports are growing more slowly,

resulting in a record foreign trade surplus of CZK 37.5 billion (about USD 1.8 billion). Analysts attribute the surplus to the economic recovery in the Eurozone and particularly in Slovakia (note: Germany and Slovakia are the top two trading partners. End note). Skoda Auto, the country's largest exporter, announced earlier this year that it was introducing Saturday production to meet soaring demand for its cars aboard. This is all happening while the Czech Crown continues to appreciate against the Euro. Private sector analysts point out that the market still believes the Czech Crown is 6 - 7% below the equilibrium foreign exchange rate, although that gap is slowly closing

----
CREDIT BUBBLE??

¶4. Alongside record export growth, household consumption is the leading source of Czech GDP growth. Consumption accounted for over a third of the 6.1% GDP growth in 2006, and consumption as a share of GDP has been rising steadily from 2.5% in 2005 to 4.8% in 2006 and to 5.6% in 2007. Since 2003, there has been a stable 30% growth annually in household credit, most of it in the form of mortgage lending (note: average mortgage rate is around 4%. End note). The main reason for the increase is that the Czech Republic has been getting by on "cheap money," with interest rates and bond yields consistently lower than those in the Eurozone. Because the growth began from a low base, only recently have household credit figures become significant in absolute terms despite four years of steady growth. Czech National Bank figures indicate that household credit/GDP ratio is 17% in the Czech Republic compared to 54% in the Eurozone, and more importantly, that this ratio is 40% below the long term equilibrium rate.

¶5. The Czech National Bank concluded in its recent presentation on a possible credit bubble that while household debt is on the rise at a significant rate, the pace is still relatively slow and the household debt/GDP ratio remains at about one third the average of developed economies. Therefore, while there is some risk especially for the lowest 20% income bracket, there is not a general macroeconomic risk. Meanwhile, private sector analysts warn of a slow down in structural growth, pointing to a slow down in fixed capital formation (from a growth rate of 7.6% in 2006 to 1.5% in 2007), and continue to pressure the government to reign in public finances and push for more radical reforms than the current economic reform package in Parliament.

2008 BUDGET HANGS ON FATE OF REFORM PACKAGE

¶6. Finance Minister Miroslav Kalousek (Christian Democrat) announced after a June 11 cabinet meeting that the Czech state budget for 2008 will have a deficit of CZK 78.4 billion (3% of GDP), down from the estimated deficit of CZK 91.3 billion in 2006 (3.9% of GDP). However, 2008 figures are pending passage of the economic reform package (ref A). Forecasted budget deficits for 2009 and 2010 are 2.6% of GDP and 2.3% of GDP, respectively. Once again (ref B), ministry reserve funds (funds carried over from one year to next) reportedly amounting to CZK 50 - 60 billion (or 2% of GDP) are a major stumbling block in terms of budget transparency. As a result, Finance Minister Kalousek has stipulated that from now on, ministries can only keep reserve funds with the consent of the Finance Ministry. The system of ministry reserve funds was put in to place as a way to curb end of fiscal year spending, but has now taken on a life of its own.

¶7. To reach the 3% of GDP deficit figure in 2008, the largest cuts are planned at the regional development ministry (-25.6%), agriculture ministry (-16.1%), culture ministry

(-14.8%) and industry ministry (-5.4%). Spending will rise at the interior ministry (2.4%) and the defense ministry (0.5%). The Minister of Culture has been the most vocal in terms of publicly decrying these cuts, while the Minister of Defense has also warned that her paltry budget will mean the army cannot do much more than participate in ceremonial parades. Such public comments are doing little to support the tough fight the coalition faces in Parliament for both the economic reform package and the 2008 budget.
GRABER